European Stability Mechanism

ESM Management Comments on Board of Auditors' Annual Report to the Board of Governors for the period ended 31 December 2014

Dear Chairperson,

I would like to thank you for the opportunity to provide management comments on the Board of Auditors' Annual Report to the Board of Governors for the period ended 31 December 2014.

During the past year, the ESM management continued its collaborative relationship with the Board of Auditors. In 2014, the Board of Auditors held nine meetings and met once with the Board of Directors. Furthermore, the Chairperson of the Board of Auditors met with the Chairperson of the Board of Governors and attended the annual meeting of the Board of Governors. To date in 2015, the Board of Auditors has held four meetings. During these meetings, the Board of Auditors was regularly updated on ESM activities, the work of the ESM governing bodies, and other relevant issues and developments. Key staff members, including the ESM management, devoted considerable time and effort to discuss relevant issues, to submit written notes in response to questions raised, and to provide any other cooperation and assistance needed for the successful discharge of the mandate of the Board of Auditors.

Furthermore, the Board of Auditors met regularly with the internal audit function and monitored and reviewed the work of the external auditor. In response to the previously issued Board of Auditors' recommendation, the ESM performed a competitive procurement procedure for the selection of an independent external auditor for the financial years 2014–2016. To ensure full transparency and process quality, the ESM invited members of the Board of Auditors to serve as independent observers. The ESM management also specifically reflected the Board of Auditors' access to the working papers of the external auditor as a mandatory requirement for the engagement. PricewaterhouseCoopers, Luxembourg ("PwC") obtained the highest score in the procurement procedure and was subsequently appointed by the Board of Governors as the independent external auditor for a three-year term.

The Board of Auditors, as part of its duties, also reviewed the ESM financial statements as of 31 December 2014 (the "Financial Statements") as well as the working papers of the external auditor on the statutory audit of the Financial Statements. Subsequently, the Board of Auditors prepared a report in respect of the Financial Statements which is included in the ESM 2014 Annual Report along with the Financial Statements and the external auditor's opinion.

Audit Procedures Conducted in 2014

AUDIT PROCEDURES CONDUCTED BY THE BOARD OF AUDITORS

The ESM is subject to significant independent audit review throughout the year, as well as at year-end. In addition to the annual external audit, the Board of Auditors carried out several independent audits in accordance with Article 30 (3) of the ESM Treaty. In January 2014 the Board of Auditors carried out an audit of the ESM Risk Management, and in November 2014, an audit of the ESM Lending Operations. Furthermore, in February 2015, a follow-up audit of the ESM Risk Management was conducted.

In line with Article 24 (5) of the ESM By-Laws, the Board of Auditors appointed two subject matter experts from the German Supreme Audit Institution (Bundesrechnungshof) to support its audit work. The ESM dedicated significant time and effort to providing all the necessary cooperation and support required for the successful completion of these audits.

AUDIT PROCEDURES CONDUCTED BY THE INTERNAL AUDIT FUNCTION

The Internal Audit function reported that the 2014 Audit Plan approved by the ESM management and presented to the Board of Auditors, had been accomplished and that the ESM had made sustained efforts in the clearance of outstanding internal audit recommendations. During the past year, the Internal Audit function performed eight audits, on matters such as business continuity, asset and liability management, outsourcing controlling, funding, as well as investment and treasury. No high-risk recommendations were outstanding at the end of March 2015. The ESM management agreed that, going forward, greater emphasis would be placed upon the timely closure of internal audit recommendations, including those classified as medium and low risk.

The Internal Audit function had full, free and unrestricted access to the Board of Auditors throughout the year. There have been seven meetings between the Internal Audit function and the Board of Auditors in 2014 and three further meetings to date in 2015. The Internal Audit function reported to the Board of Auditors on: the results of the internal audits conducted, the progress in implementing the Annual Audit Plan; and, on a quarterly basis, the implementation status of the internal audit recommendations as well as the recommendations issued by the Board of Auditors and the independent external auditor.

AUDIT PROCEDURES CONDUCTED BY THE INDEPENDENT EXTERNAL AUDITOR

The independent external auditor PwC carried out the statutory audit and issued an unqualified auditor's report confirming that based on the audit, the Financial Statements give a true and fair view of the ESM financial position, financial performance and cash flow as of 31 December 2014. The statutory audit consisted of a preliminary audit conducted from November through December 2014, and a final audit review of the Financial Statements conducted from January through March 2015. As part of its annual audit, PwC also reviewed the principal internal control procedures in place in order to ensure the accuracy and reliability of ESM accounting records and the safekeeping of assets. The independent external auditor conducted the audit in accordance with the International Standards on Auditing as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier". During the extensive tests of controls performed as part of the statutory audit, no exceptions were noted. Furthermore, PwC confirmed that unlimited access to documents and staff had been granted and noted very good cooperation by the ESM management.

ESM Internal Control Framework

Since the last Board of Auditors' Annual Report to the Board of Governors in June 2014, the ESM has progressed significantly in consolidating and finalising processes, procedures and internal controls across all areas of the institution.

The ESM recognises the importance of effective internal controls which provide the foundation for the safe and sound operation of the institution. In October 2013, as part of the maturing of the institution, the Board Risk Committee supported the implementation of the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations.

Since then, the ESM has made important strides in further developing its internal controls with the objective of completing a comprehensive and effective internal control system aligned with best practices by the end of 2015. During the past year, the ESM developed an Internal Control Roadmap which identified the remaining elements outstanding and the steps required to achieve this objective. To address these, the ESM rolled out a major institution-wide project and dedicated significant internal and external resources during 2014 and 2015 to finalise the ESM internal control framework. The project is currently 75 percent complete and all outstanding elements will be fully in place as of year-end 2015.

With the completion of the Internal Control Roadmap, the ESM will translate the Basel Committee's internal control principles into relevant entity level, process level, and information technology controls, consistent with the nature, complexity and risks inherent in ESM activities. The internal control framework will thus complement the three lines of defence governance model which the Board of Directors established with the ESM Risk Policy.

The independent external auditor acknowledged these efforts, noting good progress on the recommendations issued in last year's Management Letter. PwC confirmed that the internal control environment had significantly improved compared to the previous year in terms of staff allocated to the second and third line of defence as well as the organisational effort dedicated to the strengthening of internal controls.

I now turn to the detailed recommendations issued in the Board of Auditors' Annual Report to the Board of Governors. In line with Article 24 (8) of the ESM By-Laws, the ESM management would like to provide the following comments in this regard:

1. Follow-up to the 2013 Board of Auditors' Annual Report to the Board of Governors

- ESM Internal Control Framework

As noted earlier, the ESM substantially enhanced its internal control framework over the past year in order to meet best practice standards. As such, the ESM rolled out a major institution-wide project and deployed significant resources to the strengthening of the internal control system in order to fully align with the Basel Committee's Framework for Internal Control Systems in Banking Organisations. The ESM made this alignment one of its institutional priorities and these efforts will allow the ESM management to confirm the adequacy and effectiveness of ESM internal controls as of 31 December 2015.

- ESM Financial Controls and Financial Reporting

As part of the ongoing internal control initiative, the ESM strengthened the Finance & Control function and its underlying controls. As such, procedures and controls over the completeness and accuracy of accounting entries were enhanced.

To address fully the recommendations issued by the Board of Auditors and the independent external auditor, the ESM also implemented an IT accounting module for its financial system in May 2015. The module automates the generation of accounting entries for all financial transactions and reduces the number of manual interventions required. The ESM expects that these efforts should fully address the recommendations issued in this regard.

- "Fit for purpose" Analysis of the ESM accounting framework

On 13 December 2012, the Board of Directors adopted a resolution implementing the EU Accounting Directive (Fourth Council Directive 78/660/EEC of 25 July 1978, as amended) and the EU Banking Directive (Council Directive 86/635/EEC of 8 December 1986, as amended) as the applicable ESM accounting framework. The Board of Auditors approved this decision on 16 January 2013 subject to the subsequent completion of a "fit for purpose" analysis of the adopted ESM accounting framework. Accordingly, the ESM performed its first "fit for purpose" analysis in May 2014, after completion of the first full financial year of activity. This in-depth analysis was performed by internal resources with external expertise provided by Deloitte, Luxembourg.

The "fit for purpose" analysis concluded that the approved ESM accounting framework fits the specific purpose of the ESM, its political mandate and long-term financial assistance strategy, while providing all relevant information to the addressees of the Financial Statements.

The analysis was extensively discussed with the Board of Auditors and updated to reflect the comments provided. Following these discussions, the Board of Auditors agreed to conclude its deliberations on the matter, subject to the ESM performing a continuous review and assessment of the suitability of the ESM accounting framework in case of changes in ESM activities or the accounting landscape.

Accordingly, the ESM is monitoring the accounting environment with view to any upcoming changes and developments:

On 29 June 2013, the new EU Accounting Directive (Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013) was published in the Official Journal of the European Union. This new Directive repeals the current EU Accounting Directive. The ESM will adhere to the same transposition period applicable to the Member States and will therefore implement the Directive for the financial year commencing on 1 January 2016 and onwards.

The new EU Accounting Directive re-casts the current EU Accounting Directive and Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts. Consequently, many of the provisions in the new EU Accounting Directive have been carried over from earlier directives. The ESM is currently assessing the implications for the financial reporting process and will finalise a comprehensive gap analysis in preparation of the application of the new EU Accounting Directive in 2016.

In addition to the applied ESM Accounting Framework, the ESM is continuing to closely follow the developments in relation to the International Financial Reporting Standards ("IFRS"), including the IFRS 9 Financial Instruments, which will become effective no earlier than 2018.

The ESM is assessing the implications of the new EU Accounting Directive as well as any developments regarding the IFRS in consultation with external accounting experts. In addition, the ESM seeks regular information exchanges with peer institutions on these matters.

As such, based on the continuous assessment performed by the ESM, neither ESM activities and operations, nor current legislation have changed significantly since the approval of the applied accounting framework by the Board of Directors in December 2012 and the Board of Auditors in January 2013. Therefore no revision of the applied accounting framework is currently required.

- Adoption of the "EU Regulatory Framework" and ESM Procurement Policy

The ESM has noted that the Board of Auditors reiterated its recommendation that "the ESM adopts the EU regulatory framework as its own". As already outlined in previous years, this frame of reference does not reconcile directly with the ESM status as an international financial institution outside the EU framework. The ESM regulatory frame of reference is the ESM Treaty ratified by the 19 euro area Member States, and the ESM By-Laws, as adopted by the Board of Governors.

This rationale also applies to the ESM procurement policy. Taking this into account and similar to other international financial institutions, the ESM had initially implemented a procurement framework corresponding to its legal status as an international financial institution. While such procurement policy observes the fundamental principles of the EU Directive on Public Procurement of fair treatment, transparency, non-discrimination, mutual recognition and proportionality, it also reflects the specific context and operating model of the ESM.

In response to the recommendation of the Board of Auditors, the ESM extensively reviewed various alternatives for the further development of its procurement framework as well as the associated costs and benefits linked to these alternatives. Following a technical consultation with experts from the ESM Members and a subsequent discussion with the Board of Directors in May 2015, the ESM is currently in the process of implementing the thresholds and key elements of the EU Directive on Public Procurement while preserving a certain degree of efficiency and flexibility in the procurement procedures and timeframes.

The ESM will thus address the Board of Auditors' recommendation later in 2015 by implementing a "substance over form" approach to its alignment with the EU public procurement rules, commensurate with its special mandate, relative size and operating model.

2. Findings and Recommendations of the 2014 Board of Auditors' Annual Report to the Board of Governors

EXTERNAL AUDIT

- Procurement procedure for the external auditor and Board of Auditors' access to the working papers of the external auditor

The ESM performed a competitive procurement procedure for the selection of the independent external auditor for the 2014 - 2016 ESM statutory audits. To ensure full transparency and process quality, the ESM invited members of the Board of Auditors to serve as independent observers. PwC obtained the highest score amongst all candidates for the engagement and was subsequently appointed by the Board of Governors for a three-year term.

The audit engagement letter reflected the Board of Auditors' requirements on the terms of the external audit engagement, including the Board of Auditors' access to the working papers of the independent external auditor.

- Long-form audit report

Regarding the Board of Auditors' recommendation for the issuance of a long form report by the independent external auditor, the ESM would like to recall that this topic was discussed during the joint Board of Directors and Board of Auditors meetings on 13 June 2013 in Rome and on 13 June 2014 in Lisbon. The Board of Directors repeatedly supported the view that a long form report would not be suitable for the ESM as an international financial institution. Long form reports are generally a requirement that national bank supervisors issue for banking institutions. Furthermore, such a long form report and the related additional audit procedures may not fall within the scope of the external auditor's mandate pursuant to the ESM By-Laws.

Since 2013, the external auditor has been complementing the Management Letter with an additional "Special Topic Report" on a matter relevant to the financial reporting process selected in consultation with the Board of Auditors. As such, the 2014 Special Topic Report assessed the ESM management reporting system and its linkages to the Financial Statements.

Furthermore, for 2015 and onwards the ESM is planning to look into the preparation of an additional report in line with Article 11 of the recently issued Regulation (EU) No 537/2014 on specific requirements regarding statutory audits of public-interest entities. Such an additional report could replace the 2015 Special Topic Report if it is found to be better suited to addressing the Board of Auditors' recommendation in this regard.

- Management Letter recommendations

The independent external auditor confirmed overall good progress in addressing the recommendations issued in the 2013 Management Letter. Out of three recommendations the external auditor included in last year's Management Letter, one has been completed and closed and no new findings or recommendations have been issued for this year.

As outlined above, the ESM made significant progress on the two remaining recommendations which relate to the strengthening of the internal control environment, and the accounting system and organisation. With the completion of the Internal Control Roadmap and the automated accounting module, both of these recommendations should be fully addressed as of year-end 2015.

INTERNAL AUDIT

- Staffing of the internal audit function

In accordance with the Board of Auditors' recommendation, the ESM recruited a second internal auditor as of the beginning of June 2014. Two experienced auditors now staff the Internal Audit function. They will continue to have access to external experts for the completion of the Annual Audit Plan agreed with the Board of Auditors and the ESM management. This combined sourcing model reflects the overall ESM operating model and ensures additional internal audit resources and specialised technical skill that specific audits may require.

The ESM management will continue its efforts to proactively support and strengthen the internal audit

function as a third line of defence and to address any outstanding internal audit recommendations in a timely manner.

- "Right to audit" clause for external service providers

The ESM has developed a "right to audit" clause and has been successful in gradually introducing this legal clause into contracts with key suppliers, as noted by the Board of Auditors. The ESM has also progressed considerably in its negotiations on such a clause with the remaining existing suppliers and will strive to include the "right to audit" clause in all future outsourcing arrangements. The ESM's ability to incorporate the clause depends however on the counterparty's agreement, which may not always be forthcoming despite sustained ESM efforts.

ESM RISK MANAGEMENT AUDIT

- Distinction between first and second lines of defence

In April 2014, the ESM centralised all embedded risk functions in the Risk department. The first and second line of defence teams were clearly delineated, and a revised organisational chart of the Risk function has been issued and submitted to the Board of Auditors.

This re-organisation completed the design of the ESM three lines of defence governance model achieving a clear separation between the first and second lines of defence. It was endorsed by the Board Risk Committee and effectively implemented the Board of Auditors' recommendation.

In addition, the ESM completed the staffing of the second line of defence with the recruitment of additional risk officers who support the established senior risk management team.

With regard to the recommendation on legal and reputational risks, the ESM Communications and Legal teams already undertake a number of activities to actively monitor and manage these risks. Furthermore, the Internal Risk Committee exercises effective oversight over these risks. The Chief Spokesperson and the General Counsel attend all Internal Risk Committee meetings and when necessary, the ESM escalates any reputational or legal risk issues to the Board Risk Committee. As part of the Internal Control Roadmap, written operating procedures for managing reputational and legal risks have been drawn up with clearly assigned roles and responsibilities within these processes.

- Further development of the risk management elements and policies

The ESM Risk Policy, which the Board of Directors approved in September 2013, envisages several sub-policies with further implementation detail to be approved by the Internal Risk Committee and the ESM Managing Director. These remaining sub-policies, as listed, are currently being finalised. The priorities in this process have been identified in the Risk Management Self-Assessment exercise presented to the Board Risk Committee on 30 June 2014. The ESM will conduct a second Risk Management Self-Assessment exercise in 2015.

AUDIT OF ESM LENDING OPERATIONS

- Early Warning System

An Early Warning System for the ESM lending portfolio is a requirement of the ESM Treaty and is reflected in the ESM High Level Principles for Risk Management and the ESM Risk Policy.

The ESM designed the current Early Warning System in 2013. The system was subsequently discussed with the Board Risk Committee and approved by the Board of Directors in 2014. It aims to capture the ability of a country to cover upcoming payments to the ESM, and thus to prevent a situation where a repayment default could trigger a surprise capital call for ESM Members.

The Early Warning System was designed to be a streamlined process that operates with a high degree of reliability and accuracy, and is supported by all ESM Members based on the legal right of the ESM to demand information from a beneficiary Member as part of contractual information undertakings. Extending the data to a somewhat longer horizon could be beneficial to the ESM in compiling its liquidity assessment, taking into account that the margin of uncertainty increases with the projection horizon. Such a change can, however, only be implemented with the support of the ESM Members. The ESM will therefore approach the Board Risk Committee to understand its view on the provision of further information. In this context, the ESM will also review whether the Early Warning System reporting could be done on a quarterly basis.

In closing, I hope that the above comments are helpful as they provide the ESM management's perspective on the matters raised, and illustrate the considerable progress and effort the ESM has made in addressing the Board of Auditors' recommendations.

The ESM is appreciative of the constructive feedback and support that the Board of Auditors has provided over the past year. Going forward, the ESM will continue to foster the mutually constructive, yet appropriately independent relationships among the ESM management, the Board of Auditors, as well as the internal and external auditors.

The ESM management continues to be confident that its policies, procedures and staff will succeed in delivering the ESM mandate and in ensuring effective control mechanisms.

I look forward to continuing our good working relationship in 2015 and beyond.

Luxembourg, 4 June 2015,
Klaus Regling
Managing Director